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NO. 94-1292

Supreme Court, U.S.
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In the
Supreme Court of the United States

OCTOBER TERM, 1994

BRUCE BABBITT,
SECRETARY OF THE INTERIOR, ET AL.,
PETITIONERS

v.

PHILLIPS PETROLEUM COMPANY AND
ATLANTIC RICHFIELD COMPANY,
RESPONDENTS

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF OF ATLANTIC RICHFIELD COMPANY IN OPPOSITION

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QUESTION PRESENTED

Whether the Interior Department may retroactively change a regulation establishing criteria for determining the royalty value of natural gas liquids produced under federal mineral leases without first complying with the notice-and-comment requirements of the Administrative Procedure Act.

RULE 29.1 STATEMENT

Atlantic Richfield Company has no parent company, and it has only the following non-wholly owned subsidiaries:

85819 Canada Limited
AAPSS93, Inc.
AAPSS94, Inc.
Agro Internacional, S. de R. L. de C.V.
Alyeska Pipeline Service Company
AM/PM Japan Co. Ltd.
Arco Chemical Company
ARCO Solar Nigeria Ltd.
Badger Pipeline Company
Black Lake Pipe Line Company
Blair Athol Coal Pty., Limited
Colonial Pipeline Company
Compania de Petroleo Ganso Azul, Ltda.
Cook Inlet Pipe Line Company
Dalrymple Bay Coal Terminal Pty., Ltd.
Dixie Pipeline Company
East Heidelberg Salt Water Disposal Co.
East Texas Salt Water Disposal Co.
Iricon Agency Ltd.
Kenai Pipe Line Company
Kuparuk Transportation Capital Corp.
Kuparuk Transportation Company
Logan Aluminum Inc.
Lyondell Petrochemical Company
Olympic Pipe Line Company
Platts Pipe Line Company
Prince William Sound Oil Spill Response Corporation
Tecumseh Pipe Line Company
Texas-New Mexico Pipe Line Company
Vastar Resources, Inc.

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STATEMENT

The Administrative Procedure Act ("APA") requires that agency rules be published in the Federal Register at least 30 days before they become effective. 5 U.S.C. § 553(d). Affected parties must be given prior notice of and an opportunity to comment on the proposed rules. 5 U.S.C. § 553(c). Only "interpretative rules, general statements of

policy, [and] rules of agency organization, procedure, or practice . . ." are exempt. 5 U.S.C. § 553(b)(3)(A).

The Fifth Circuit held that new criteria adopted by the Interior Department for establishing the royalty value of natural gas liquids produced under federal mineral leases did not fall within any of the APA's enumerated exceptions. Accordingly, since Interior had not promulgated the rules in accordance with the APA's notice-and-comment requirements, the Fifth Circuit held that they could not be enforced retroactively against Atlantic Richfield Company.

Atlantic Richfield Company, through its unincorporated division ARCO Oil & Gas Company ("ARCO"), leases federal lands for oil and gas exploration, development, and production.[1] As lessee, ARCO pays royalties to the government based on the value of the production saved, removed, or sold from the leased premises. 43 U.S.C. § 1337(a)(1)(B). Interior, through its Minerals Management Service ("MMS"), administers the leases and collects the royalties due thereunder.

When ARCO produces natural gas that contains a high volume of liquefiable hydrocarbons (commonly known as "wet" gas), it sometimes processes the gas to separate the liquids from the dry methane, or "residue" gas. The liquids are then fractionated to separate the various individual products, such as ethane, propane, butane, and

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[1] During the pendency of this litigation, all of the affected leases were assigned by Atlantic Richfield Company to a newly created subsidiary, Vastar Resources, Inc.

natural gasoline (natural gas liquid products or "NGLPs"). This case concerns the valuation, for royalty purposes, of NGLPs that ARCO produced from its federal offshore leases during the period October 1980 through February 1988, and that it used internally in its own manufacturing operations.

During 1980-1988, the period relevant to this case, the governing regulation authorized the MMS Director to establish the royalty value of federal lease production, provided he gave due consideration to several enumerated factors:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

30 C.F.R. § 206.150 (1987).

Believing that it was in compliance with this regulation, ARCO valued its internally used NGLPs for royalty purposes based on third-party transactions in the market place as reported in a variety of publications. That ARCO's valuations were, in fact, in compliance with the gov-

erning MMS regulation was confirmed by a 1984 audit by Interior's Office of Inspector General ("OIG"). The OIG audited ARCO's royalty payments on NGLPs produced at the Grand Chenier processing plant and concluded that ARCO did not owe any additional royalties on its internally used NGLPs. Later that same year, however, Interior developed a new set of rules for valuing NGLPs. These new rules were set forth in an unpublished agency paper referred to as the "Procedure Paper."

In place of the range of different types of prices that were required to be considered under the regulation (area, actual, posted, and regulated prices), the Procedure Paper mandated the use of only one type of price — the spot market price. Even more specifically, the Procedure Paper mandated the use of a particular spot market price — the price published in a single designated bulletin. For example, for NGLPs produced from federal leases in the Gulf of Mexico, the Procedure Paper specified the use of the spot market price published for the Mont Belvieu, Texas, trading center by Oil Buyer's Guide for 1980 to 1982 and by Platt's Oilgram for 1983 forward.

Spot market prices are not even mentioned in the regulation. Posted prices are mentioned; however, as was correctly found by the Fifth Circuit, posted prices and spot market prices are not the same. A posted price is a publicly announced price at which a purchaser is willing to buy a certain type and amount of petroleum product. By comparison, spot market prices reflect actual transactions, usually on a short-term or one-time basis. Pet.App. 11a.

ARCO was first advised of the Procedure Paper's ex-

istence in August 1985, almost a year after it was developed. At that time, ARCO was advised that the MMS had *reaudited* the royalties previously audited by the OIG, this time using the 1984 Procedure Paper. ARCO was further advised that, based on the MMS' application of the Procedure Paper, additional royalties were found to be due for the period 1980-1983.

Since the Procedure Paper did not exist at the time these royalties were paid, ARCO had used a different methodology (based on third party transactions reported in a variety of publications — not just the one bulletin later specified by the Procedure Paper) to determine the fair market value of its internally used NGLPs. Notably, there has been no determination by the MMS that ARCO's methodology was unreasonable. Nor has there been a determination that ARCO's methodology resulted in the payment of any less royalties during the audit period than would have been payable using the Procedure Paper's values. Rather, additional royalties were assessed only because ARCO's values *for certain months* were less than the Procedure Paper's values. This distinction is significant, as is illustrated by the following example.

If, during a two-month period in 1980, ARCO's values were 15¢ and 25¢, respectively, and the Oil Buyer's Guide spot market price for the Mont Belvieu, Texas, trading center for the same months was 20¢ for each month, retroactive application of the Procedure Paper would require ARCO to pay additional royalties for the first month based on the Procedure Paper's 20¢ value, but ARCO would not be allowed any credit for the higher 25¢ value that it used in the second month. Under the

Procedure Paper, ARCO would have to pay additional royalties on 5¢ for the first month even though the overall value under its methodology was exactly the same as the value under the Procedure Paper — a total of 40¢ for the two months in question.

As is illustrated by this example, ARCO is not being required to pay additional royalties because its methodology produced a value that was less than fair market value. According to the Procedure Paper, 40¢ — the value ARCO used — was fair market value for the two months in question. Thus, Interior is wrong when it asserts that the issue presented by its Petition is whether Interior should be precluded from enforcing its determination that ARCO failed to pay royalties on fair market value. There has been no determination that ARCO failed to pay royalties on fair market value — only a determination that ARCO's values did not coincide, on a month-by-month basis, with the spot market price published in the particular bulletin specified in the Procedure Paper. This, however, is not surprising since, at the time most of the royalties were paid, the Procedure Paper did not even exist. ARCO therefore had no way of knowing that the bulletin specified in the Procedure Paper should have been used.

There is, of course, no reason why ARCO could not, and would not, have used the bulletin specified in the Procedure Paper if it had known of the Procedure Paper's requirements. This certainly would have been easier than ferreting out actual transactions from various published sources in order to determine the fair market value of its internally used NGLPs. Even more importantly, if ARCO had had timely notice of the Procedure Paper's requirements, it could have avoided taking an unnecessary

risk that its values would not exactly coincide with the Procedure Paper's values on a month-by-month basis, with the attendant risk that additional royalties would be assessed. Indeed, as the above example illustrates, if ARCO had had timely notice of the Procedure Paper's requirements, it could have used the "correct" bulletin, *paid exactly the same amount of royalties,* and not have been subject to an assessment for additional royalties.

Believing that it should have been given advance notice of the Procedure Paper's valuation criteria and an opportunity to comment on those criteria *before* they became effective, ARCO appealed the MMS assessment administratively, first to the MMS Director and then to Interior's adjudicatory tribunal, the Interior Board of Land Appeals ("IBLA"). The IBLA rejected ARCO's APA arguments, stating that the Procedure Paper did not have the force and effect of law and that the IBLA could decline to follow it if the IBLA chose to do so. The IBLA, however, did not choose to decline to follow the Procedure Paper. Rather, with only a slight modification, the MMS' use of the Procedure Paper was affirmed, and ARCO was directed to pay the additional royalties found to be due. Since the IBLA's decision constituted final agency action, ARCO filed suit for judicial review.

Shortly after the IBLA's decision was rendered, three additional MMS orders were issued.[2] These orders require ARCO to recalculate its royalties, using the Procedure Paper as modified by the IBLA, for all internally used NGLPs produced from all of ARCO's federal offshore

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[2] Orders dated September 6, 7 and 29, 1989, Pet.App. 71a, 86a and 91a.

leases, for each and every month during the period October 1980 through February 1988.[3] Because the IBLA already had decided the issue, ARCO filed an immediate suit for judicial review. Notably, Interior agreed in the trial court that it would have been futile for ARCO to exhaust its administrative remedies with respect to these three MMS orders in light of the IBLA's prior decision.[4]

The district court upheld Interior's actions. The Fifth Circuit reversed, holding that the IBLA's decision, as well as the three MMS orders, were invalid. The Fifth Circuit recognized that the notice-and-comment requirements of the APA " 'were designed to assure fairness and mature consideration of rules of general application.' " Pet.App. 9a-10a, *quoting NLRB v. Wyman-Gordon Co.*, 394 U.S. 759, 764, 89 S. Ct. 1426, 1429, 22 L. Ed. 2d 709 (1969). Looking beyond at the label given to the Procedure Paper by the MMS and the IBLA, the Fifth Circuit looked at how the agency in fact had applied the Procedure Paper. Notwithstanding the agency's assertion that the Procedure Paper was merely a clarification of the existing regulation, the Fifth Circuit found that "it effects a change in the method used by MMS in valuing NGLPs." Pet.App. 8a. *See also id.* at 4a (the Procedure Paper established "new criteria" for valuing NGLPs. As such, the Procedure

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[3] The MMS acknowledged in the September 6 order that ARCO's royalties actually were overpaid, not underpaid, for the period reviewed. Despite this fact, ARCO was directed to recalculate its royalties for all other periods because of the so-called "systemic" error identified by the auditors, *i.e.*, ARCO's failure to use the particular price bulletin later specified by the Procedure Paper.

[4] Defendants' Response to Phillips' Motion for Preliminary Hearing, filed in the district court on September 24, 1990, at 6.

Paper changed, rather than simply interpreted, the existing regulation. Citing cases from various jurisdictions, including *Brown Express, Inc. v. United States*, 607 F.2d 695 (5th Cir. 1979), the Fifth Circuit held that the Procedure Paper established substantive rules that could not be applied retroactively because Interior had failed to comply with the notice-and-comment requirements of the APA. Accordingly, the court held that ARCO could not be required to retroactively recalculate and pay additional royalties based on the new valuation criteria set forth in the Procedure Paper.

ARGUMENT

Interior argues that this Court should grant its Petition for two reasons. First, Interior asserts that the Fifth Circuit's decision has broad and potentially serious implications for the efficient functioning of the administrative process because it precludes an agency's compliance personnel from applying initial compliance policies without having to go through the burdensome notice-and-comment procedures of the APA. Interior also asserts that this case presents an appropriate occasion to settle a recurrent issue of considerable importance under the APA, *i.e.*, the validity of the "substantial impact" test articulated in *Brown Express*. Neither argument has any merit.

The Fifth Circuit's decision in this case does not impose undue burdens on Interior. In the past, Interior has had no difficulty whatsoever complying with the APA when it adopted new criteria for establishing fair market value for royalty purposes. Its auditors also have not previously had any trouble complying with the agency's own requirement that they use the royalty valuation rules

and policy guidance that were in effect during the period covered by the audit — not new criteria developed later.

Interior's more general concern regarding the needs of governmental compliance personnel to make initial enforcement decisions is similarly unfounded — at least under the facts here. This case does not involve the application of an initial compliance policy that will be enforced — and perhaps modified — in subsequent orders and adjudicatory proceedings. Rather, this case involves a final agency requirement that new valuation criteria be applied retroactively — rigidly and without exception — to all internally used NGLPs produced from all of ARCO's federal offshore leases, for each and every month during the period October 1980 through February 1988. Moreover,the result for other lessees has been exactly the same.

Finally, whatever the Court may think of the legal test articulated in *Brown Express,* this is not an appropriate case for reviewing that test. The Fifth Circuit's decision in this case was based on its conclusion that the Procedure Paper established new criteria for valuing NGLPs — criteria that did not merely implement the governing regulation, but that changed the requirements of the regulation. Given these facts, it is abundantly clear that Interior violated the APA under any legal standard that might be applied.

I. The Court Should Not Consider Interior's New Argument That The Procedure Paper Is Not A Rule.

Interior argues for the first time in its Petition to this Court that "there is a substantial question whether the paper fits the APA's definition of a 'rule' at all." Pet. 15. Interior did not raise or brief this issue in the courts below. Pet.App. 6a (the agency did not argue that its action was not a rulemaking, only that the Procedure Paper was exempt from the APA's notice-and-comment requirements). Absent unusual circumstances (which Interior has not shown to be present here), this Court should not consider a new issue that was not raised below.[5]

In any event, there is no authority (and Interior cites none) for the startling proposition that the Procedure Paper cannot be considered to be an APA "rule" because it "was compiled by subordinate officials." Pet. 15. To the contrary, manuals compiled by lower-echelon agency personnel acting in the course and scope of their duties unquestionably are "rules" within the APA's broad definition.[6]

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[5] *E.g., Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 1649, 118 L. Ed. 2d 280 (1992); *Bendix Autolite Corp. v. Midwesco Enterprises, Inc.*, 486 U.S. 888, 895, 108 S. Ct. 2218, 2223, 100 L. Ed. 2d 896 (1988).

[6] *E.g., Guernsey Memorial Hosp. v. Secretary of HHS*, 996 F.2d 830 (6th Cir. 1993), *cert. granted*, 114 S. Ct. 1395 (1994) (argued Oct. 31, 1994) (agency manual on Medicare reimbursement clearly was a rule; the only issue before the Court is whether it was a substantive or interpretative rule).

II. Interior's Concern That Undue Burdens Are Being Placed On The Administrative Process Is Unfounded.

The United States Department of the Interior has a right that few, if any, private mineral lessors are able to secure from their lessees — the right to determine the value of the minerals produced, which in turn determines the amount of royalties owed. This right, while extensive, is not unlimited.

The regulation in effect during the period relevant to this case *required* the MMS Director, in making value determinations, to give due consideration to a number of specifically enumerated factors, including the price received by the lessee, the price received by others for like-quality production, posted prices, regulated prices, and other relevant matters. 30 C.F.R. § 206.150 (1987).

Lease limitations also exist. Like the regulation, ARCO's leases authorize Interior to establish reasonable minimum values for royalty purposes *only after* due consideration is given to the same factors enumerated in 30 C.F.R. § 206.150 (1987). Many of these leases further provide that "[e]ach such determination shall be made *only after due notice* to the lessee and a reasonable opportunity has been afforded the lessee to be heard." (Emphasis added.)

Interior itself has recognized that the APA imposes a similar limitation. For example, in *Texaco Inc.*, GS 119 O&G (Jan. 15, 1979), the Acting Director of the U. S. Geological Survey (the MMS' predecessor) invalidated two

unpublished notices that established new royalty-valuation criteria similar to those at issue here. The Acting Director correctly concluded that "the Geological Survey has in effect changed the regulations without complying with the requirements of the Administrative Procedure Act" — regulations essentially identical to the regulations in effect during the period at issue here.

Notably, Interior did not argue in *Texaco,* as it does here, that giving lessees notice of new royalty-valuation criteria before they become effective will somehow threaten the orderly conduct of the government's administrative business. Indeed, Interior routinely has followed the APA's notice-and-comment procedures when establishing new criteria for determining fair market value for royalty purposes.[7]

Interior's concern regarding undue burdens being placed on governmental compliance personnel, who must be allowed to make initial enforcement decisions, is likewise unfounded. Notably, the burdens complained of are not simply the result of the Fifth Circuit's decision. Congress, in the Federal Oil and Gas Royalty Management Act ("FOGRMA"), expressly prohibits Interior's auditors from retroactively applying new valuation criteria. 30 U.S.C. § 1711(c) (the agency "shall conduct audits and reconciliations of lease accounts in conformity with the

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[7] *See, e.g.,* 53 Fed. Reg. 1184 (Jan. 15, 1988) (oil product valuation); 53 Fed. Reg. 1230 (Jan. 15, 1988) (valuation of gas and NGLPs); 47 Fed. Reg. 16,423 (Apr. 16, 1982) (notice of hearing on fair market value of offshore gas for royalty purposes); 42 Fed. Reg. 22,610 (May 4, 1977) (rules for determining onshore gas royalty values), subsequently repealed in part by Notice to Lessees No. 5 Gas Royalty Act of 1987, Public Law 100-234, enacted Jan. 6, 1988.

business practices and recordkeeping systems which were required of the lessee by the Secretary for the period covered by the audit").[8]

Interior has not previously complained that this statutory requirement poses a threat to the orderly conduct of the agency's business. To the contrary, Interior itself has acknowledged that its auditors cannot, and should not, apply new valuation criteria retroactively:

> All product value guidance issued to royalty payors which describes methods for calculating fair market value for purposes of royalty calculations shall be prospective in nature. *In auditing past activities of royalty payors,* the Office of the Inspector General and *the MMS will apply the regulations and policy guidance which were in effect at the time that this specific royalty transaction or transactions occurred.*[9]

Interior also is incorrect when it suggests that this case involves only the application of an initial compliance policy that will be enforced — and perhaps modified — in subsequent orders and adjudicatory proceedings. First, In-

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[8] Given the FOGRMA's prohibition against the retroactive application of new valuation criteria, Interior has an additional barrier to overcome in seeking reversal of the judgment in this case. Under this Court's decision in *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 109 S. Ct. 468, 102 L. Ed. 2d 493 (1988), administrative rules cannot be given retroactive effect unless there is an express statutory grant of authority to enact retroactive rules. There is no such express statutory grant here; instead, the applicable statute expressly provides to the contrary.

[9] Memorandum of the Acting Director, MMS, dated June 29, 1983 (emphasis added).

terior's assertions to the contrary notwithstanding, the Procedure Paper does not allow lessees an opportunity to demonstrate fair market value by other methods. The Procedure Paper does allow lessees selling to affiliates under non-arm's-length contracts to show that those contracts have characteristics similar to arm's-length contracts.[10] That, however, is not the case here. ARCO did not sell to an affiliate, it used its liquids internally. In this circumstance, the Procedure Paper does not allow the lessee to demonstrate fair market value by other means. Rather, it mandates the use of its "yardstick" value. Indeed, the Procedure Paper itself expressly proclaims that "the yardstick value *is considered fair market value.*"[11]

Interior's assertion that this case only involves an initial enforcement policy also ignores the fact that ARCO already has appealed to both the MMS Director and the IBLA. With only a slight modification, the MMS' use of

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[10] Pet.App. 136a. Even in this situation, the lessee is merely afforded an opportunity to establish that the terms of its non-arm's-length contract are similar to the terms of other arm's-length contracts; it is not given an opportunity to independently establish that its contract price constituted fair market value. *See, e.g., Shell Offshore Inc.*, 116 IBLA 246, 255 (1990).

[11] Pet.App. 136a (emphasis added). Notably, an earlier draft of the Procedure Paper would have allowed lessees an opportunity to demonstrate fair market value by other means: "Before MMS undertakes any billing, using these prices, companies should be given the opportunity to present other sources they believe to be more valid (should they disagree with the MMS's valuation procedure)." This language was stricken by the Associate Director for Royalty Management, who wrote: "Don't agree! They can appeal but I don't want to negotiate specific valuation determinations with them."

the Procedure Paper was affirmed as final agency action. Moreover, the two administrative decisions cited by Interior for the proposition that an auditor's initial nonbinding application of the Procedure Paper can perhaps be modified as the result of subsequent adjudicatory proceedings both involved non-arm's-length affiliate sales — a different situation than is involved here. As noted above, the Procedure Paper expressly allows lessees with non-arm's-length contracts to show that their contracts are similar to arm's-length contracts; the IBLA merely required Interior to follow that rule.[12] By comparison, in cases similar to this one involving internally used NGLPs, the IBLA has shown no flexibility whatsoever.[13]

Any doubt regarding the final and mandatory nature of the Procedure Paper as an inflexible rule of royalty valuation is laid to rest when one considers the three self-audit orders that also are at issue in this case. These orders direct ARCO to recompute its royalties, using the valuation methodology required by the Procedure Paper as modified by the IBLA in ARCO's prior appeal, for all internally used NGLPs produced from all of ARCO's federal offshore leases, for every month during the period October

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[12] *See Phillips Petroleum Co.*, 117 IBLA 255, 264-65 (1991); *Amoco Production Co.*, 112 IBLA 77, 79 (1989).

[13] *See, e.g., Union Oil Co. and Union Exploration Partners, Ltd.*, 111 IBLA 369 (1989); *Mobil Oil Corp.*, 112 IBLA 56 (1989); *Cities Serv. Oil & Gas Corp.*, 112 IBLA 89 (1989); *Cities Serv. Oil & Gas Corp.*, 113 IBLA 255 (1990); *Union Oil Co. of Cal. and Union Exploration Partners, Ltd.*, 116 IBLA 8 (1990). Indeed, in light of the IBLA's inflexible application of the Procedure Paper, a notice-and-comment rulemaking would have been required even if the Procedure Paper itself never existed. *See e.g., First Bancorporation v. Bd. of Governors*, 728 F.2d 434, 438 (10th Cir. 1984).

1980 through February 1988. ARCO did not appeal the orders administratively. Rather, it filed an immediate suit for judicial review. Nevertheless, Interior conceded in the trial court that requiring ARCO to pursue administrative appeals of the orders would have been futile, since the IBLA already had finally decided the issue.

The agency's far-reaching self-audit orders are sustainable only if the agency has correctly identified an error (here, ARCO's failure to use the Procedure Paper's values for royalty purposes) that is "systemic" in nature, *i.e.*, an error that results from the use of an incorrect royalty formula.[14] Interior's position that the self-audit orders in this case are valid thus concedes that the Procedure Paper is not merely a provisional, non-binding guideline for its own auditors' internal use, but a royalty formula capable of "systemic" application.

Additionally, unless the Procedure Paper is viewed as mandating a particular royalty formula that leaves no room for discretionary determinations to be made in its application, the challenged orders would run afoul of the settled rule that Interior's discretionary authority to value federal lease production for royalty purposes cannot be delegated to Interior's lessees.[15]

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[14] *See, e.g., Phillips Petroleum Co. v. Lujan*, 963 F.2d 1380, 1386 (10th Cir. 1992) (Interior lawfully can require lessees to correct repeated royalty underpayments caused by "systemic deficiencies"); Pet.App. 43a (the district court in this case rejected ARCO's argument that the self-audit requirements of the orders were unlawful because the court found that the orders merely required ARCO "to recalculate royalties based on the correct formula").

[15] *E.g., Amoco Production Co. v. Lujan*, 877 F.2d 1243, 1250 (5th Cir.), *cert. denied*, 493 U.S. 1002 (1989).

If, as Interior now contends, the Procedure Paper provides only a flexible guideline or policy to be applied on a case-by-case basis, the self-audit requirements of the challenged orders cannot be sustained and Interior's discretionary valuation authority has been improperly and unlawfully delegated. On the other hand, if, as the Fifth Circuit held, the Procedure Paper imposes a mandatory, non-discretionary formula for determining value, the APA was violated when Interior failed to comply with the act's notice-and-comment requirements.

Under the facts of this case, Interior's concern regarding the creation of undue administrative burdens is unfounded.

III. Given The Fifth Circuit's Factual Findings, The Court's Decision Is Not Dependent On The "Substantial Impact" Test Of *Brown Express.*

The factual findings on which the Fifth Circuit's decision was based are succinctly stated in the decision as follows:

> The rule narrowly restricts the discretion of MMS officials in determining the value of NGLP's. It forecloses other valuation methods by prescribing binding valuation criteria. Although the regulation allows the use of *posted* prices in determining the value of NGLP's, the Procedure Paper mandates the use of *spot* prices. Thus, the Procedure Paper does not even comport with the regulation in using posted prices. Moreover, the Procedure Paper eliminates the other four factors in determining the value of the NGLP's.

> This change in valuation technique dramatically affects the royalty values of all oil and gas leases.

Pet.App. 10a-11a. While these facts certainly support the Court's conclusion that the Procedure Paper violated the APA under the "substantial impact" test of *Brown Express*, they also compel the conclusion that the APA was violated under any test that might be applied.

With regard to the question of whether the Procedure Paper falls within the APA's exception for interpretative rules, Interior does not quarrel with the Fifth Circuit's test, which was whether the Procedure Paper merely *interpreted* the then-existing royalty valuation regulation, or whether it effected a *change* in that regulation. Instead, Interior challenges only the Fifth Circuit's finding that, under the facts of this case, a change was effected, *i.e.*, that the royalty-valuation criteria established in the Procedure Paper were new. Pet. 18-19. As noted above, the version of the facts on which Interior relies is demonstrably incorrect. The Procedure Paper does indeed mandate a particular valuation methodology for internally used NGLPs; it does not allow lessees to demonstrate fair market value by other methods.

Noteably, this is not a case where the governing statute or a regulation previously adopted by the agency is silent on the issue addressed. Nor is there any ambiguity in the regulations such that, in determining whether a conflict with later unpublished guidelines exists, the agency's interpretation of its regulations is arguably entitled to deference.[16] Rather, the regulation at issue in this case

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[16] *See, e.g., Guernsey Memorial Hosp. v. Secretary of HHS*, 996 F.2d 830 (6th Cir. 1993), *cert. granted*, 114 S. Ct. 1395 (1994) (argued Oct. 31, 1994).

expressly states that, in determining royalty values, the MMS Director shall consider certain enumerated factors. For the agency to make another, unmentioned factor determinative of value clearly is legislative — not interpretative — under the very cases that Interior cites as having applied the proper legal standard.[17]

Interior's alternative argument that the Procedure Paper is an exempt general statement of policy is similarly based on an argument that the facts were not as the Fifth Circuit found them to be — not an argument that the Fifth Circuit misapplied the law. Pet. 19-21. In particular, Interior contends that the Procedure Paper is exempt as a general policy statement because its ultimate impact "was and remains heavily dependent on subsequent review and application in particular adjudicatory proceedings." *Id.* at 20-21. As discussed above, the Fifth Circuit found otherwise.

Given the Fifth Circuit's factual finding that the Procedure Paper is mandatory and final, not provisional and subject to later modification on appeal in particular adjudicatory proceedings, the Procedure Paper cannot be deemed to be an exempt policy statement, even under the cases cited by Interior. As these authorities make clear, an agency pronouncement is not a general statement of policy

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[17] *See, e.g., American Mining Congress v. MSHA*, 995 F.2d 1106 (D.C. Cir. 1993) (a rule that effectively amends a prior legislative rule is legislative; not interpretative); *Industrial Safety Equip. Ass'n, Inc. v. EPA*, 837 F.2d 1115, 1120-21 (D.C. Cir. 1988) (rejecting the "substantial impact" test but still recognizing that the agency's unpublished guide would have violated the APA if it had narrowed or altered the grounds for certifying lawful respirator types, *i.e.*, if it had narrowly limited agency discretion to act).

if the pronouncement is binding and finally determinative of the issues or rights to which it is addressed.[18]

With respect to the question of whether or not the Procedure Paper is exempt from the APA's notice-and-comment requirements because it is a rule of agency organization, procedure, or practice, Interior again relies on its characterization of the Procedure Paper as being only provisional and nonbinding. Pet. 21-22. As previously noted, the IBLA repeatedly has applied the Procedure Paper in a final, unwavering and binding manner — and the MMS has directed ARCO to apply the Procedure Paper in the same way. Moreover, with respect to the three self-audit orders that require ARCO to apply the Procedure Paper to revalue all of the internally used NGLPs produced from all of its federal offshore leases, for all months during the period October 1980 through February 1988, Interior itself recognized that administrative appeals would have been futile, since the IBLA already had decided the issue.

Notably, this is not a case where the Fifth Circuit's application of the "substantial impact" test of *Brown Express* resulted in the APA's notice-and-comment requirements being extended to agency action that is otherwise exempt under the APA.[19] Rather, the question in this case is whether the Procedure Paper falls within one of the statutory exemptions. In particular, the Fifth Circuit applied the "substantial impact" test to determine whether

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[18] *See, e.g., Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 38 (D.C. Cir. 1974).

[19] *See, e.g., Rivera v. Becerra*, 714 F.2d 887 (9th Cir. 1983), *cert. denied*, 465 U.S. 1099 (1984).

the Procedure Paper falls within the APA's exemption for rules of agency organization, procedure, or practice.

Interior rejects this test; however, under the cases relied on by Interior as applying the correct test, the result is exactly the same. For example, in *JEM Broadcasting Co., Inc. v. FCC*, 22 F.3d 320, 326-27 (D.C. Cir. 1994), the court held that substantive rules alter the rights or interests of parties, whereas procedural rules do not — that a rule affecting the time for filing an application was procedural, whereas a rule affecting the substantive criteria to be applied to the application would be substantive. Similarly, in *Southern California Edison Co. v. FERC*, 770 F.2d 779, 783 (9th Cir. 1985), the court held that agency rules relating to the procedural aspects of the FERC's approval of rates — interventions, requests for refunds of interim rates and for final confirmation and approval — were exempt, but only because these *procedural* provisions did not affect the *substance* of the rate proceedings.

Under these cases, the Procedure Paper clearly is substantive, not procedural. The Procedure Paper does not regulate the form of the agency's proceedings; rather, it goes to the substance of the rights at issue in the agency's proceedings. This is because it dictates the substantive criteria to be employed in determining value, not merely the procedures to be followed in raising valuation issues within the agency.

In sum, the Procedure Paper meets all recognized criteria for being a substantive rule because it:

- imposes substantive obligations upon lessees;

- is determinative of the valuation issues addressed;

- rewrites the existing regulation by narrowly constricting the discretion of MMS officials in determining the value of NGLPs; and

- forecloses alternative valuation methods, thereby conclusively affecting the rights of federal lessees.

Interior does not suggest that different criteria should be applied. Rather, it argues that, as a factual matter, the Procedure Paper is only a non-binding guideline to be used by Interior's auditors in making initial enforcement decisions. As the Fifth Circuit correctly found, however, the facts are otherwise.

In place of the flexible approach required by the governing regulation, which mandated a case-by-case consideration of multiple factors, the Procedure Paper substituted a single criterion — the published spot market price in a particular bulletin for a particular location — that establishes the value of internally used NGLPs. This type of conclusive determination is the hallmark of a substantive rule. The Fifth Circuit's decision therefore was correct under any test that might be applied.

CONCLUSION

The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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